(7)

No. 91-615

In The

Supreme Court of the United States

October Term, 1991

ALLIED-SIGNAL, INC.
as successor-in-interest to
The Bendix Corporation,

Petitioner,

v.

DIRECTOR, DIVISION OF TAXATION,

Respondent.

On Writ Of Certiorari
To The Supreme Court Of New Jersey

BRIEF FOR RESPONDENT

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QUESTION PRESENTED

Whether the unitary business principle permits a state to tax a nondomiciliary corporation on a portion of the capital gain derived from a minority stock interest when, as here, the stock is integral to the corporation's operational and financial strategies but there is no unitary relationship between the corporation and the issuer of the stock.

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COUNTERSTATEMENT OF THE CASE

A. Origins of the Controversy.

This is a unitary business case involving the single issue of whether a state may impose its income-based corporation tax on an apportioned share of the capital gain realized by a nondomiciliary corporation from the sale of a minority stock interest in an unrelated domestic corporation. The case arose when petitioner's predecessor-in-interest The Bendix Corporation filed a complaint in the Tax Court of New Jersey challenging the New Jersey Division of Taxation's denial of its claims for refund of New Jersey corporation business tax ("CBT") for Bendix' 1980 and 1981 fiscal years and an assessment of additional CBT for the 1980 fiscal year (J.A. 3, ¶1).

Bendix claimed that certain capital gains and interest income realized in connection with its sale of stock in various corporations and (for 1981 only) that dividends from ASARCO, Inc. and one other corporation should not have been included in the net income base of the CBT (J.A. 9 to 11, ¶3). Bendix claimed that the inclusion of the income violated the Due Process Clause of the Fourteenth Amendment because there was no unitary business existing between it and the companies in which it had invested and whose stock it had sold (*id.*). Alternatively, Bendix claimed that, if the income were to be included in the tax base, either the Commerce Clause or the New Jersey CBT itself required an adjustment to the three-factor statutory apportionment formula to include the receipts, payroll, and property of the corporations whose stock was sold (J.A. 11, ¶¶3H, 3I).

Subsequently, Bendix dropped its claims respecting the 1980 fiscal year and many of its claims respecting the 1981 fiscal year (including its claim that the dividends from ASARCO were not unitary income), leaving only its 1981 claims that (1) the State of New Jersey could not include in the income base the capital gains realized on the sale of Bendix' 20% stock interest in ASARCO and its 100% stock interest in United Geophysical Corporation, nor the interest income earned on the proceeds of those sales, and (2) its alternative claim to factor relief (J.A. 13). In this Court petitioner has limited its appeal to the taxability of the ASARCO gain.

The three New Jersey courts that considered the case concluded, with no dissents, that the capital gains and interest income were realized in the course of Bendix' unitary business and could therefore be included in the tax base, to be apportioned under the statutory formula. All three courts denied the factor relief sought by Bendix on the ground that Bendix had made no showing that the formula operated either unconstitutionally or unfairly under the CBT statute in subjecting approximately 8% of the income in question to tax in New Jersey.[1]

B. Overview of Bendix.

Bendix was incorporated in 1929 as a manufacturer of aviation and automotive parts (J.A. 154, ¶7) and in 1937

[1] The New Jersey Tax Court noted that, "[T]here is no claim by the taxpayer of double taxation, and there is no evidence that Michigan, the state of Bendix's commercial domicile, has treated the subject income as nonbusiness income" (Pet. App. C at 65a).

received a certificate of authority to do business in New Jersey (*id.*, ¶8). During the period at issue, Bendix' corporate headquarters were in Southfield, Michigan (J.A. *id.*, ¶10). By 1970 Bendix had become a diversified manufacturer having four major operating groups consisting of the automotive group, aerospace group, forest products group, and industrial/energy group (*id.*, ¶11; J.A. 190, ¶148).[2] Bendix concedes that these diverse activities formed a single unitary business for purposes of its 1980 and 1981 New Jersey CBT returns.

During the period at issue, Bendix did business, either directly or through subsidiaries or other units, in all 50 states and 22 foreign countries (J.A. 154, ¶11). Several units in Bendix' aerospace group were based in New Jersey, as well as a unit that manufactured electric power generating systems (J.A. 161 to 162, ¶¶31-36). In addition, Bendix sold the full range of its products to New Jersey customers (J.A. 163, ¶38). There is no dispute that Bendix' activities in New Jersey were part of its unitary business (cf. J.A. 9 to 12, ¶¶3A to 3I).

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[2] As described in Bendix' 1981 Annual Report to Shareholders, the automotive group supplied systems and components for cars and trucks including a variety of replacement parts. The aerospace group provided products and services to the military, commercial, and general aviation markets and for the space program. The industrial/energy group supplied a wide range of machine tools for the metal-working industry and produced heavy-duty equipment and piping systems (J.A. 220). In forest products Bendix was vertically integrated; it owned timber, produced lumber, plywood, moldings, millwork and particleboard, and operated distribution yards catering to retail dealers (J.A. 227 to 230; J.A. 44 to 45).

C. Bendix' Acquisitions and Divestitures.

At least as early as 1965, Bendix began a program of growth and diversification through the acquisition and occasional divestiture of other corporations. In 1965, Bendix bought the stock of United Geophysical Corporation ("UGC") (J.A. 172, ¶69). According to its 1965 Annual Report to Shareholders, Bendix was accelerating its acquisitions program with the intent not only to diversify but also to achieve a better balance between its military and nonmilitary sales. UGC's business, seismic surveying, was thought to be complementary to Bendix' oceanic endeavors (*id.*, ¶70; J.A. 173, ¶¶71,73).

In the years subsequent to 1965, Bendix' acquisitions and dispositions continued:

- **1966** – seven acquisitions (J.A. 184, ¶132).
- **1967** – five acquisitions; disposition of the marine division (J.A. 185 to 186, ¶¶133, 134).
- **1968** – five acquisitions (*id.*, ¶135).
- **1969** – six acquisitions; three dispositions (J.A. 187, ¶¶137, 138).
- **1970** – one acquisition (Bendix' largest to date) (J.A. 188, ¶139; J.A. 184, ¶130; J.A. 154 to 155, ¶¶11, 13).
- **1971** – six small acquisitions plus a 50% interest in two European companies (J.A. 188, ¶140).
- **1973** – two acquisitions plus the Autolite spark plug manufacturing facility and the Autolite trademark from the Ford Motor Company (*id.*, ¶142).

° **1977** – one acquisition (J.A. 190, ¶129).

° **1978** – three acquisitions plus 20% of the shares of ASARCO (Bendix' largest purchase to date); disposition of a portion of Bendix Home Systems (*id.* ¶¶149, 150).

° **1979** – two acquisitions (J.A. 191, ¶152).

° **1980** – acquisition of a machine tool manufacturer for $300.7 million (Bendix' largest acquisition to date); one disposition (*id.*, ¶153).

° **1981** – disposition of the entire forest products group including Bendix Forest Products Corporation, Bass & Company, Caradco, and Modern Materials; disposition of UGC; disposition of Bendix' interest in ASARCO (J.A. 192, ¶156), for total net cash of approximately $700 million (J.A. 136).

° **1982** – unsuccessful tender offer for 70% of the shares of Martin Marietta Corporation for a total of $1.5 billion (J.A. 193, ¶162; J.A. 82). Allied acquired a majority of Bendix' shares (J.A. 194, ¶¶164, 165).

The foregoing acquisitions ranged over a variety of industries, some related to Bendix' existing businesses and others in unrelated areas such as seismic surveying (J.A. 173, ¶¶71, 73), fiber optics (J.A. 185, ¶132), and, in 1970 (the year in which Bendix acquired the American Forest Products Company), forest products (J.A. 184, ¶130; J.A. 45 to 46). The acquisitions increased steadily in size. The major dispositions in 1981 were followed in 1982 by the tender offer for Martin Marietta.

Over this period, Bendix' Annual Reports to Shareholders continually stressed the objective of diversification to protect the company against downturns in any one segment of its business (J.A. 172, ¶70; J.A. 186, ¶136; J.A. 188, ¶141; J.A. 189, ¶147; J.A. 192, ¶158). In 1969, the company's chairman pointed out that Bendix' growth during the prior 10 years had been achieved in large part through acquisitions (J.A. 187, ¶136), and that trend continued through 1979. Some of the acquisitions were obviously consistent with Bendix' strategic goals for each major operating group. For instance, the acquisition of Coin Millwork, a manufacturer of wood moldings, was consistent with the company's strategic goal for the forest products group of integrating forward in the distribution chain (J.A. 190, ¶147; J.A. 160, ¶29; J.A. 184, ¶129; J.A. 191, ¶152).

The 1980 and 1981 dispositions were part of a major restructuring intended to concentrate the company more intensively on the high technology aspects of its business (J.A. 191, ¶154; J.A. 59 to 60). Implementing this shift in strategy, Bendix began to sell its noncore businesses (J.A. 191, ¶153; J.A. 56), specifically those included in its natural resources group (J.A. 191, ¶155), purchased stock in high technology businesses, formed a technical ventures group, established an Advanced Technology Center, and established within the Bendix planning department a screening program to select a major acquisition candidate in a high technology business (J.A. 191, ¶154; J.A. 160, ¶30; J.A. 77 to 78).[3] The screening program lasted for nearly two years and led to the selection of Martin Marietta Corporation as the target (J.A. 160, ¶30).

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[3] Bendix acquired 7% of RCA's stock, not 70%.

The proposed acquisition of Martin Marietta was consistent with the company's long-term goal for the aerospace group of moving into the production of entire systems and subsystems rather than remaining a subcontractor of component parts (J.A. 80 to 81; J.A. 160, ¶29; J.A. 194, ¶163; J.A. 265) and would have insulated Bendix from excessive exposure to the automotive market (J.A. 268 to 269).

D. Bendix' Centralized Management.

In January 1977, William M. Agee became chief executive officer of Bendix and remained in that position until June 1983 (J.A. 156, ¶15). During this period Agee had direct input into the corporation's operations, particularly its acquisitions and divestitures.[4]

Every year, each operating unit and subsidiary prepared a five year strategic plan, which described the business outlook for the particular entity involved and, in some cases, discussed acquisition and divestiture possibilities (J.A. 158, ¶24). Each such plan was reviewed at the major operating group level. The Bendix planning department reviewed each major group's plan, and subsequently each plan was reviewed by Agee and others prior to being incorporated into the corporate-wide strategic plan for that year (*id.*, ¶25).

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[4] As to Agee's involvement in ongoing operations, see J.A. 17, 25-26, 40; as to his involvement with acquisitions and divestitures, see J.A. 42, 57, 60, 35, 50, 86, 80, 68-69.

Besides its role in the ongoing review of Bendix' strategic plans, the Bendix planning department developed long and short range business proposals for the corporation. These efforts included the evaluation of acquisition candidates (J.A. 159, ¶27).

E. Purchase of ASARCO Stock.

Bendix began planning for the acquisition of a natural resources company in the spring of 1977. In April of that year, Agee received a memorandum from the Bendix planning department presenting a survey of natural resource companies (J.A. 231 to 232). The memorandum notes that natural resource companies tend to be countercyclical to the overall economy and would "offer Bendix an opportunity for diversifying" (J.A. 233).

At the end of March 1978, Agee presented to the long-range planning committee of the Bendix Board a memorandum, authored by Jerome Jacobson, head of the company's planning department, with input by Agee, on long-range growth and acquisition planning for the company (J.A. 165, ¶44; J.A. 87). According to Jacobson and Agee, the company's financial and managerial strength "warrant several major moves aimed at growth and diversification for the 80's," including "investment in other basic resources that are now depressed and undervalued but that offer strong profit possibilities for the 80's" (J.A. 87). The reasons for acquiring a copper mining company, such as ASARCO, include their undervaluation (J.A. 93) and the threat of worldwide shortages in basic commodities (J.A. 95), including copper (J.A. 98). The authors state that they favor acquiring 20% rather than a

majority or 100% of ASARCO's shares because the smaller financial commitment will permit Bendix to complete its other acquisitions in forest products and industrial energy, and a 20% position will give Bendix "time to become more familiar with the company and the industry before chancing a significantly larger position" (J.A. 104). According to Jacobson and Agee, Bendix will seek representation on ASARCO's Board to gain information about the company and the industry preparatory to deciding "whether to enlarge or sell our holdings" (J.A. 107 to 108).

The long-range planning committee approved the acquisition of a 20% interest in ASARCO, and on April 13, 1978, Agee requested approval from the Bendix Board to make the acquisition (J.A. 166, ¶¶46, 47). Agee asserted that the acquisition would reduce Bendix' dependence on the slower growing areas of its business, such as aerospace, would generate good cash flow "to meet growing capital needs, particularly in aerospace/electronics," and would broaden Bendix' holdings of basic commodities including forest products and non-fuel minerals (J.A. 120).

The Bendix Board approved the acquisition of up to 21% of the common stock of ASARCO at a price not to exceed $134 million (J.A. 166, ¶49). The stock purchase agreement provided that ASARCO would recommend the election of William Agee and a Bendix outside director to ASARCO's Board (J.A. 168, ¶53).

Ultimately, Bendix acquired 20.6% of ASARCO's stock for a total purchase price of $127.6 million (J.A. 167, ¶¶51, 52). Approximately $17.5 million of the purchase

price derived from internally generated funds, while the balance was borrowed (*id.*, ¶52).[5] There is no evidence in the record to indicate that Bendix did not deduct the interest incurred on these borrowed funds as an expense of its unitary business on its New Jersey CBT returns.

F. Holding of ASARCO Stock.

Agee and the Bendix planning department's analysis of the worldwide copper industry and of ASARCO's potential proved to be accurate. Bendix' financial statements show that ASARCO contributed 82 cents per share to Bendix' 1979 earnings per share of $7.10 and approximately $2.22 per share to Bendix' 1980 earnings per share of $7.68 (J.A. 169, ¶¶59, 60).[6]

In September 1979, with the backing of the Bendix Board, Agee made a proposal to the ASARCO Board that the two companies merge. ASARCO rejected the proposal (J.A. 169, ¶61).

During the period that Bendix held 20.6% of the stock of ASARCO, the only contacts between the operations of Bendix and the operations of ASARCO were the presence of Messrs. Agee and Baldridge on ASARCO's Board (J.A.

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[5] The $17.5 million in internally generated funds presumably derived from the divestment of other entities (J.A. 131 to 132; J.A. 190, ¶149).

[6] Bendix' share of ASARCO's earnings was *not* taxed by New Jersey. The earnings contribution was for financial reporting purposes only. For New Jersey tax purposes, Bendix reported 50% of the ASARCO dividends in the preapportionment tax base. N.J. Stat. Ann. § 54:10A-4(k)(5) (West 1986).

168, ¶53), a minute amount of sales by ASARCO subsidiaries to Bendix (J.A. 170, ¶62), and quarterly reviews of ASARCO's books to enable Bendix to report the ASARCO investment on the equity method of accounting (J.A. 168, ¶56).

G. Sale of ASARCO Stock.

The sale of Bendix' interest in ASARCO in 1981 for $335.9 million (J.A. 172, ¶¶66, 67) was part of a major restructuring of the company, which was intended to eliminate Bendix' noncore businesses, reduce the company's dependence on the automotive industry, and focus the company more intensively in high technology areas (J.A. 63 to 78; J.A. 65; J.A. 70 to 72; J.A. 171, ¶64; J.A. 191, ¶¶154, 155). According to Agee, the greater focus on high technology businesses was motivated by a combination of factors — higher expected returns, a safer, more secure position for the company and its employees, a sense that the noncore businesses did not fit the long-term strategy of the company, and a concern that their future returns would not compare favorably with their immediate prior returns or to the potential return from selling the businesses and investing the proceeds in marketable securities (J.A. 72; J.A. 76 to 77).

The ASARCO stock sale and other divestitures generated net cash proceeds of approximately $700 million (J.A. 136), which were invested in highly liquid, interest bearing obligations with maturities of less than 90 days (J.A. 181, ¶117; J.A. 182, ¶123).[7] The cash was thus readily

[7] In the spring of 1981, Bendix purchased approximately four million of its own shares for a total price of $257.5 million (J.A. 182 to 183, ¶¶124, 126, 127).

available in the event Bendix determined to make an acquisition (J.A. 70 to 71) and was in fact instrumental in Bendix' attempt to acquire Martin Marietta Corporation in the summer of 1982 (J.A. 193, ¶161; J.A. 81; J.A. 136).

H. New Jersey's Corporation Business Tax.

New Jersey's corporation business tax is a franchise tax that was measured during the years at issue by a tax on net worth (essentially book equity)[8] and a tax on net income. *N.J. Stat. Ann.* § 54:10A-2 ("*N.J.S.A.*"); *N.J.S.A.* 54:10A-5. The income measure, which was added to the statute in 1958, 1958 *N.J.Laws, c.* 63, is based upon "entire net income" defined as federal taxable income before the net operating loss deduction and special deductions. *N.J.S.A.* 54:10A-4(k). Unlike the majority of states, New Jersey does not distinguish between so-called business income and nonbusiness income.[9] Ever since the enactment of the income measure in 1958, all income, subject to constitutional constraints, has been included in the net income base. Dividends from subsidiaries owned to the extent of 80% or more are excluded from the base, while dividends from all other corporations are excluded to the

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[8] The net worth measure was repealed in 1985. 1985 *N.J.Laws, c.* 55.

[9] See the *amicus* brief of the State of California filed in support of New Jersey for a discussion of business income and the unitary business principle. *See also* Peters, "What Is Nonbusiness Income?,-Part I," 1 *State Tax Notes* 511 (Dec. 1991) and Peters "What Is Nonbusiness Income?,-Part II," 2 *State Tax Notes* 13 (Jan. 1992).

extent of 50%. *N.J.S.A.* 54:10A-4(k)(5). Corporations that maintain "a regular place of business outside [the] State" are permitted to apportion their entire net income using the standard three-factor apportionment formula, which averages the ratios of in-state property, payroll, and receipts to total property, payroll, and receipts. *N.J.S.A.* 54:10A-6. Apportionment is available to all corporations, whether domestic or foreign, and as to all income, whether operating income or investment income. Under *N.J.S.A.* 54:10A-8, a taxpayer's apportionment factor may be adjusted in order to achieve a fair apportionment of income to the State. Finally, New Jersey does not permit or require combined reporting, *i.e.*, the combination of income and apportionment factors of related corporations conducting a unitary business. *N.J. Admin. Code* tit. 18, § 7-11.15 (1991) (Da1).[10]

These statutory provisions produced the following results:

– Although constitutionally permissible, the income of Bendix and the income of its functionally integrated, controlled subsidiaries were not included in a combined report. *Cf. ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 312, *reh'g. denied* 459 U.S. 961 (1982); *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 168, *reh'g. denied* 464 U.S. 909 (1983).[11]

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[10] The designation "D-" refers to the appendix attached to this brief.

[11] The *Container* case involved combined reporting as applied by California. Under that methodology the income of

(Continued on following page)

– Bendix conceded that its entire net worth, including the value of the ASARCO stock, was apportionable for New Jersey purposes.[12]

– Bendix did not contest the inclusion of 50% of the ASARCO dividends in apportionable net income for the 1977-1980 years and has withdrawn its challenge on this issue for 1981.

– Over Bendix' protest, the New Jersey Division of Taxation included the ASARCO stock gain in apportionable net income, applied Bendix' statutory apportionment factor of approximately 8% (J.A. 154, ¶5) and then the CBT tax rate of 9%. *N.J.S.A.* 54:10A-5(c).

Petitioner insists that this single aspect of the ASARCO stock interest -- the gain on sale -- is beyond New Jersey's taxing power such that the state tax,

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separate, majority owned, unitary affiliates is included in the income base subject to apportionment, while intercorporate transactions such as dividends from subsidiary to parent are eliminated. The apportionment factor of each member of the unitary group compares the property, payroll, and receipts within the taxing state of that member to the total property, payroll, and receipts of the group. *Container* at 168, n.5, 174; *see* Peters, "Supreme Court's *Mobil* Decision on Multi-state Income Apportionment Raises New Questions," 54 *J. Tax'n* 36, 39 (1980); Keesling and Warren, "The Unitary Concept In The Allocation of Income," 12 *Hastings L. J.* 42, 60-61 (1960); Hellerstein, *State Taxation I Corporate Income and Franchise Taxes* ¶8.12 (1983).

[12] The unitary business principle applies to taxes other than income taxes. *See e.g. Trinova Corp. v. Michigan Dept. of Treasury,* 111 *S.Ct.* 818 (1991) (value added tax).

amounting to .72% (8% x 9%) of the total gain of $211 million, cannot constitutionally be imposed.

I. The Decision Below.

The Supreme Court of New Jersey held that the ASARCO stock gain was apportionable because Bendix "had a business function of corporate acquisitions and divestitures that was an integral operational activity" (Pet. App. A at 18a to 19a). The court reasoned:

> The tests for determining a unitary business are not controlled by the relationship between the taxpayer recipient and the affiliate generator of the income that becomes the subject of State tax. . . . [T]here is no bright line controlling test. What controls is the underlying activities that reflect the economic realities of the corporate business (*id.* at 18a).

Significant to the court's analysis were the role of the sale of the ASARCO stock in Bendix' subsequent attempt to acquire Martin Marietta (*id.* at 7a, 9a to 11a, 20a) and the central role played by Bendix' chairman William Agee (*id.* at 4a, 5a, 10a to 11a). Bendix' sale of its interest in ASARCO and its tender offer for Martin Marietta were, the court indicated, two steps in "an ingrained acquisition-divestiture policy designed to expand and enhance [Bendix'] existing operations as well as to move it into other fields of business" (*id.* at 18a). Bendix' "acquisition-divestiture policy" was not simply a means of diversifying into areas "distinct from the corporation's main line of business" but was itself a business function (*id.* at 18a to 19a). On this basis, and on the differing factual records,

the New Jersey Supreme Court distinguished this Court's opinion in *ASARCO* (*id.* at 21a).

SUMMARY OF ARGUMENT

New Jersey may tax an apportioned share of the ASARCO stock gain because the acquisition, holding, and sale of the stock were integrally related to Bendix' concededly unitary business. Since the ASARCO stock interest was itself integrally related to Bendix' unitary business, there is no need to show a unitary relationship between the operations of Bendix and the operations of ASARCO. The unitary relationship between the ASARCO stock interest and Bendix' otherwise unitary operations satisfies the unitary business principle and thus the Due Process and Commerce Clauses.

There is no hard and fast definition of a unitary business, but in its latest decision on the subject, the Court declared that a unitary relationship between a corporation's in-state and out-of-state activities exists if there is a concrete relationship between the in-state and out-of-state activities producing a flow of value that is more than a flow of funds from a passive investment or a discrete business. *Container*, 463 *U.S.* at 166.

The record facts establish a sufficient "sharing or exchange of value" between Bendix' unitary business and the ASARCO stock interest to conclude that the ASARCO gain was earned in the course of Bendix' unitary business:

1. Diversification and growth through acquisitions were central to Bendix' longstanding operational strategy for overall corporate profitability, and the ASARCO stock purchase and sale were part of that strategy. *Container*, 463 *U.S.* at 180, n.19.

2. The ASARCO stock purchase and sale were intended to meet and did meet the financial needs of Bendix' unitary business. *ASARCO*, 458 *U.S.* at 337 (O'Connor, J., dissenting). The ASARCO investment was made in part to generate cash to meet the needs of Bendix' core businesses, and the cash proceeds from the ASARCO stock sale in fact created the additional cash and debt capacity that Bendix needed to make a major acquisition in the aerospace industry.

3. Bendix benefitted from "strong centralized management and controlled interaction," *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 *U.S.* 207, 224 (1980), that linked the ASARCO stock interest and Bendix' unitary business. That link is most evident in the "hands-on" involvement of Bendix' chairman/CEO William Agee and the Bendix planning department in the acquisition, holding, and disposition of the ASARCO stock.

4. The ASARCO stock generated more than a flow of funds to Bendix from a passive investment. Bendix used its substantial minority interest to gain two seats on ASARCO's Board and thereby acquire knowledge of ASARCO's business and the nonferrous metals industry before chancing a larger, controlling interest, an interest that Bendix briefly sought to attain.

There is little dispute that income earned on short-term investments of working capital is apportionable

without regard to the business relationship between the issuer and the recipient. The reason that such investments are unitary and therefore apportionable is that they are integrally connected with the recipient's business operations. Stock investments may be just as related to a taxpayer's unitary business as the short-term investment of its working capital albeit the relationships, as here, may take a different form. As the Court made clear in *Mobil Oil Corp. v. Commissioner of Taxes*, 445 *U.S.* 425, 440 (1980), the form of the investment should not determine whether it is or is not unitary. Investments can be as much a part of a corporation's unitary business as its traditional manufacturing activities. Bendix' chairman/CEO viewed the corporation as "pools of assets," consisting variously of Bendix' manufacturing businesses and a portfolio of investments (J.A. 133 to 137).

A majority of the Court has not recognized the apportionability of investment income based on the integration of an investment with a corporation's otherwise unitary business, but the Court has not previously been presented with facts to support such a holding. There were no record facts in either *ASARCO* or *F.W. Woolworth Co. v. Taxation & Revenue Dept.*, 458 *U.S.* 354 (1982), linking the corporations' *investments* in their subsidiaries to the operations of the parent companies. Here those facts are present and serve to distinguish both *ASARCO* and *Woolworth*.

ASARCO and *Woolworth* thus do not preclude New Jersey's apportioned taxation of the ASARCO gain. However, the Court should qualify the majority's broad statement in *ASARCO* that, absent a unitary link between the

payor of dividend income and the recipient, a non-domiciliary state may not apportion dividend income. *ASARCO*, 458 *U.S.* at 327. The ultimate question in a case involving the includability of income in the unitary tax base, be it sales income or investment income, is whether the *taxpayer's* activities that generated the income are integrally related to the taxpayer's unitary business. A unitary relationship between the payor of investment income and the recipient is relevant because it may evidence the necessary integration of the *investment* with the taxpayer's business, but it is not the only way of establishing that integration. *Id.* at 335-39 (O'Connor, J., dissenting); *Container*, 463 *U.S.* at 179.

ARGUMENT

THE NEW JERSEY SUPREME COURT PROPERLY HELD THAT THE ASARCO GAIN WAS APPORTIONABLE INCOME BECAUSE BENDIX CONDUCTED PART OF ITS UNITARY BUSINESS IN NEW JERSEY AND THE ASARCO STOCK INTEREST WAS AN INTEGRAL PART OF THAT BUSINESS.

A. The New Jersey Supreme Court's Analysis Was Consistent With The Court's Traditional Approach To the "Unit" Rule.

1. Function of the Unitary Business Principle.

"The Due Process Clause places two restrictions on a State's power to tax income generated by the activities of an interstate business." *Moorman Mfg. Co. v. Bair*, 437 *U.S.* 267, 272-73 (1978). First, the taxpayer must conduct some part of its activities in the taxing state, and, second, the income attributed to the state must be rationally related

to the in-state values of the enterprise. *Id.; Mobil*, 445 *U.S.* at 437. The same restrictions apply under the Commerce Clause. *Container*, 463 U.S. at 164; *ASARCO*, 458 *U.S.* at 327, *n*.23.

In the case of a corporation operating in more than one state, it is extremely difficult to determine the amount of income earned within the taxing state and thus subject to its taxing power. The paradigm is a vertically integrated company that manufactures goods in one state, sells them in another, and has its corporate headquarters in yet another. *See, e.g., Underwood Typewriter Co. v. Chamberlain*, 254 *U.S.* 113, 120 (1920); *Bass, Ratcliff & Gretton v. State Tax Comm'n*, 266 *U.S.* 271, 281-282 (1924); *Mobil*, 445 *U.S.* at 438; *Exxon*, 447 *U.S.* at 210. The unitary business principle attempts to solve the problem by determining the scope of the entire unitary business both within and without the state and apportioning the result by means of a formula reflecting the portion of the total business conducted within the taxing state. *Container*, 463 *U.S.* at 165.

2. Historically, The Court's Unitary Business Cases Have Focused On The Activities Of The Taxpayer To Determine The Scope Of The Unitary Business.

The "unit" rule was developed in the context of state property taxation of railroad and telegraph companies. The entire system was considered a "unit" and a formula (such as the ratio of in-state miles of track to total track) was applied to determine the taxing state's share of total value. *Pittsburgh, Cincinnati, Chicago & St. Louis Ry. v. Backus*, 154 *U.S.* 421 (1894); *Western Union Teleg. Co. v.*

Taggart, 163 *U.S.* 1 (1896). The rule was extended to a capital stock tax on a company lacking the "physical unity" of a railroad in *Adams Express Co. v. Ohio State Auditor,* 165 *U.S.* 194, 221 (1897), with the Court stating, "Presumptively all the property of the corporation . . . is held and used for the purpose of its business . . . " *Id.* at 227. *See also Wallace v. Hines,* 253 *U.S.* 66 (1920) (excise tax measured by value of capital stock, apportioned according to the ratio of in-state track mileage to total track mileage). In *United States Glue Co. v. Oak Creek,* 247 *U.S.* 321 (1918), the Court upheld a state tax on corporate income apportioned on the basis of in-state property and receipts compared to total property and receipts and in *Underwood,* upheld a net income tax apportioned on the basis of a single factor.

In none of these early cases was there any suggestion that the property, capital stock, or income of anyone other than the taxpayer should be considered in determining the "unit."

Later cases applied the same theory to differing kinds of businesses, in each case referencing only the taxpayer's business activities. *Bass, Ratcliff & Gretton, supra* (apportionment of operating income of foreign corporation upheld despite current year loss in taxing state); *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell,* 283 *U.S.* 123, 133 (1931) (striking down apportionment formula but affirming that a manufacturing business is generally unitary and that, "all the factors in [the] enterprise are essential to the realization of profits." *Id.* at 133); *Butler Bros. v. McColgan,* 315 *U.S.* 501, 509 (1942) (geographically divisionalized wholesaler operated unitary

business due to common ownership, centralized management, and economies of scale, and taxpayer failed to show "that income unconnected with the unitary business [had] been used in the formula." *Id.* at 509); *Exxon* (centrally managed, integrated petroleum company conducted unitary business despite its ability to source production and refining income to locations outside taxing state).

In *Mobil*, the Court dealt for the first time with non-operating income, specifically dividends from foreign subsidiaries and ARAMCO, a 10%-owned affiliate doing business abroad. Rejecting Mobil's argument that it was operating a separate holding company business in managing its subsidiaries, the Court concluded that:

> So long as dividends from subsidiaries and affiliates reflect profits derived from a functionally integrated enterprise, those dividends are income to the parent earned in a unitary business. [*Mobil*, 445 *U.S.* at 440].

Lacking direct evidence linking Mobil's subsidiary investments to its operating business,[13] the Court based its conclusion on the unitary relationships between Mobil

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[13] The record before the Court included the transcript of a hearing before the Vermont Commissioner of Taxes, most of which was taken up by discussions with counsel and legal argument, Mobil's tax returns, an exhibit listing the dividend payors, Mobil's percentage ownership of each, and the amount of dividends from each, and an unsigned stipulation of facts that provided no information as to the integration of Mobil's investments in the subsidiaries with Mobil's petroleum business. *Mobil* App. at A3 to A91.

and its affiliates but left open the possibility that a unitary business could be otherwise established. *Id.* at 435, 442.

Shortly after *Mobil* and *Exxon* were decided, the Court issued its opinions in *ASARCO* and *Woolworth*. In those cases, departing from its consistent, longstanding approach to the unitary business principle, the Court's analysis focused strictly on the relationships between the taxpayer and the payors of dividend income to determine whether the taxpayer's business was unitary. Those decisions are discussed below in Part D. It is sufficient to say here that *ASARCO* and *Woolworth* are not consistent with the Court's earlier unitary business decisions and that much of their force was defused in *Container,* which followed one year later.

In *Container,* returning to the fundamentals of the unitary business principle, the Court made clear that application of the principle entails two steps:

> [F]irst, defining the scope of the 'unitary business' of which the taxed enterprise's activities in the taxing jurisdiction form one part, and [second] apportioning the total income of that 'unitary business' between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction. [463 *U.S.* at 165].

To establish the existence of a unitary business, all that need be shown is a concrete relationship between the in-state and out-of-state activities of the business resulting in:

> [S]ome sharing or exchange of value not capable of precise identification or measurement --

> beyond the mere flow of funds arising out of a passive investment or a distinct business operation — which renders formula apportionment a reasonable method of taxation. [*Id.* at 166].

Indicia of a unitary business include " 'functional integration, centralization of management, and economies of scale;' " *id.* at 179, but a unitary relationship can be shown "in any number of ways," *id.*, and the burden of proof is on the taxpayer to show " 'by clear and cogent evidence' " that there are no unitary relationships linking the in-state and out-of-state activities of the taxpayer. *Id.* at 164.[14]

Under the Court's longstanding application of the unitary business principle, including its most recent articulation of the principle in *Container*, the New Jersey Supreme Court properly analyzed Bendix' activities (not those of ASARCO) to determine the scope of Bendix' unitary business.

B. The Record Establishes That There Was A Unitary Relationship Between Bendix' Operations And The ASARCO Stock Interest.

1. The Purchase and Sale of the ASARCO Stock Were Functionally Related to Bendix' Unitary Business.

Petitioner concedes that all aspects of Bendix' operations — aerospace/electronics, automotive, industrial/

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[14] In *Container* the unitary relationships were those between Container and its subsidiaries because the "taxpayer" for purposes of a combined report includes separate corporate entities engaged in a single unitary business. *See* above at 13, n. 11 and below at 45, n. 28.

energy, and even forest products — formed a single unitary enterprise. The record establishes that the purchase of the ASARCO stock interest was functionally integrated with that business as a whole.

The purchase served to further diversify Bendix' overall operations, a strategy that had been central to Bendix' operations since at least 1965 (J.A. 233; J.A. 120; J.A. 172, ¶70). In addition, Bendix' management believed that acquisitions were essential for the company's growth in the 1980's (J.A. 187, ¶136), a strategy that had been central to Bendix' historical approach to its operating businesses (J.A. 92). This functional integration did not take the form of, *e.g.* supplying raw materials or markets to Bendix' existing businesses, but there clearly was a "flow of value" to the rest of Bendix' operations in further insulating the company's overall profitability from the cyclical downturns in its core operating areas and fostering the future growth of the company. *See Container*, 463 *U.S.* at 178 and 180, n.19. Bendix' goal of cyclical protection and overall profitability was qualitatively no different than Exxon's search for " 'greater profits stability' " by placing its exploration/production, refining, and marketing divisions " 'under one corporate entity' " to offset economic factors in one department against those in another. *Exxon*, 447 *U.S.* at 225 (quoting the testimony of an Exxon senior vice-president). Exxon may have been using its operating divisions and Bendix a minority stock interest, but functionally they served the same purpose of ensuring overall profitability by insulating the company from downturns in any one segment of its business.

Bendix' sale of its stock in ASARCO was functionally integrated with its core businesses. Carrying out one of

the original goals of the ASARCO stock purchase, Bendix sold the ASARCO stock (along with its other natural resource companies) in part to generate the capital necessary to make a major acquisition of a high technology company. The acquisition target that Bendix selected would have achieved the long-term goal of the aerospace/electronics group of developing the capacity to manufacture entire systems rather than remaining a subcontractor of component parts (J.A. 80 to 81; J.A. 160, ¶29). Additionally, Martin Marietta's emphasis on missiles would have complemented Bendix' emphasis on aviation (J.A. 194, ¶163). Plainly, the ASARCO stock sale was not made simply to " '[add] to the riches of the corporation.' " *Woolworth* at 363, quoting *Wallace v. Hines, supra*. In the words of the New Jersey Appellate Division, the ASARCO stock purchase and disposition were "stepping stones to additional acquisitions" (Pet. App. B at 35a).

In *Container*, the Court reasoned that "capital transactions can serve either an investment function or an operational function." 463 *U.S.* at 180, n.19. Container's loans to its subsidiaries were operational in nature because their purpose was to foster the company's overseas operations. Bendix' use of the ASARCO sale proceeds in its attempt to acquire Martin Marietta similarly served an "operational function" — the growth and profitability of one of Bendix' core businesses. "[T]he resulting flow of value is obvious." *Id.* See Pet. App. A at 20a to 21a.

Petitioner suggests that the use of the ASARCO stock proceeds to further the in-state unitary activities of the taxpayer (here Bendix' aerospace activities in New Jersey)

cannot "establish a due process link between the investment and the state in which the proceeds are subsequently invested" because, at that point, the investment has been sold (Pb36).[15] Petitioner's argument would "eviscerate" the unitary business principle. New Jersey need *not* establish a direct relationship between the ASARCO stock interest and Bendix' aerospace activities in New Jersey. The requisite concrete relationship between Bendix' out-of-state activities (the sale of the ASARCO stock) and Bendix' in-state activities (its aerospace business in New Jersey), *Container*, 463 *U.S.* at 166, results from the fact that both sets of activities are within the scope of Bendix' unitary business. *Id.* at 165; *Amerada Hess Corp. v. Director, Div. of Taxation*, 490 *U.S.* 66, 73 (1989). The question is whether "the out-of-state business activity can be characterized . . . [as] a part of a unitary enterprise doing business in the State." *ASARCO*, 458 *U.S.* at 334 (O'Connor, J., dissenting). If petitioner were correct, the unitary business principle would be a virtual nullity. Ordinary manufacturing/sales income earned in one state may have no direct relationship to the same kind of income earned in another, *e.g.* Bendix' aerospace sales in New Jersey and its forest products sales in other states. The unitary link is created by centralized management, an operational strategy, or other factors, linking the disparate activities. *Cf. Butler Bros., supra*, 315 *U.S.* 501, and *see Albany Int'l. Corp. v. Halperin*, 388 *A.*2d 902, 905 (Me. 1978). Moreover, under petitioner's theory, income realized on the sale of an investment would never be

[15] The designation "Pb" refers to petitioner's brief on the merits in this Court.

unitary because, by definition, the investment is gone when the income is used in the business.

2. The Purchase and Sale of the ASARCO Stock Were Essential to the Financial Management of Bendix' Unitary Business.

The facts described in the preceding paragraphs indicate as well that the ASARCO stock purchase and sale were part and parcel of Bendix' "management of the financial requirements of its [diversified manufacturing] business." *ASARCO*, 458 *U.S.* at 337 (O'Connor, J., dissenting). One purpose in acquiring what was essentially a large supply of copper was to position Bendix to benefit from an anticipated increase in the world price of copper (J.A. 95 to 100; J.A. 123 to 125). When that anticipation materialized (with the result that Bendix nearly tripled its money in little more than three years), the company was in a position to both supply the needed capital to its aerospace activities and accomplish its long-term goal for that segment of its business of becoming a prime contractor in the aerospace industry. Much like Container's loans to its subsidiaries, the ASARCO stock purchase was part of Bendix' effort to ensure that the company would continue to grow and become more profitable. *Container*, 463 *U.S.* at 180, n.19.

3. The ASARCO Stock Interest and Bendix' Ongoing Operations were Linked by Strong Centralized Management.

In *Exxon*, the foremost factor in the Court's conclusion that Exxon conducted a unitary business was the

company's "highly integrated business which benefits from an umbrella of centralized management and controlled interaction." *Exxon*, 447 *U.S.* at 224; and *see Woolworth*, 458 *U.S.* at 370, contrasting the role of Exxon's "coordination and services management office" with Woolworth's lack of involvement in its subsidiaries' affairs.

Like Exxon's coordination and services office, the Bendix planning department coordinated the company's operational and investment activities. The planning department analyzed business trends to determine where Bendix should increase or decrease its capital investment and its research and development efforts and analyzed areas where Bendix should develop new products, either by developing them from within or through acquisitions (J.A. 159, ¶27). The planning department reviewed each major operating group's five-year strategic plan (J.A. 158, ¶25), which set forth the group's "business prospects, problems and concerns" (J.A. 158, ¶26) including opportunities for growth and in some cases possible acquisitions and divestments (J.A. 158, ¶24). The planning department developed three major strategies for growth, one of which was to move the company "into unrelated areas with strong growth potential" (J.A. 159 to 160, ¶28). As suggested by the New Jersey Appellate Division, the analysis of the ASARCO stock purchase by the Bendix planning department and Agee (J.A. 165, ¶44) demonstrates "the interdependence of Bendix's existing businesses and long-term strategic planning" (Pet. App. B. at 39a). The ASARCO stock acquisition was analyzed from the point of view of Bendix' existing businesses and its effect on Bendix' future growth. *See id.* at 37a to 38a.

During the period at issue, the Bendix chairman William Agee was closely involved with the company's operational and administrative affairs, its long-range planning, and its acquisitions program. The detail with which Agee supervised the company's operations is best exemplified by the fact that in a company having sales exceeding $4.4 billion, Agee approved all capital expenditures exceeding $100,000 (J.A. 211; J.A. 25 to 26). Agee had direct input into the memorandum to the long-range planning committee outlining management's reasons for acquiring an interest in ASARCO (J.A. 165, ¶44). Agee sat on ASARCO's Board, made the proposal to that Board to merge the two companies, and made the decision for Bendix' management to sell the ASARCO stock (J.A. 169, ¶61; J.A. 35). As CEO, Agee determined as well to sell UGC and Bendix Forest Products Corporation (J.A. 57), decided that the proceeds from the various sales should be placed in short-term securities managed by Lehman Brothers in order to ensure the ready availability of cash in the event Bendix "needed the cash to proceed" (J.A. 69 to 70), and made the decision for management to endeavor to acquire Martin Marietta (J.A. 79 to 80).

4. The ASARCO Stock Interest was not a Passive Investment.

The only aspect of the ASARCO stock interest that differentiated it from Bendix' other acquisitions was the lack of control over ASARCO. But the absence of control did not convert the ASARCO stock holding into a

"passive investment"[16] generating no more than a flow of dividends into Bendix' treasury. *Cf. Container*, 463 *U.S.* at 166. As a result of its substantial minority interest, Bendix obtained two seats on ASARCO's Board of Directors (J.A. 168, ¶53). One of the stated objectives for obtaining the Board seats was to learn as much as possible about ASARCO and the nonferrous metals industry and with that knowledge to decide whether to increase or sell the holding (J.A. 107 to 108). When ASARCO's prospects improved, Bendix made use of its entree to the ASARCO Board to propose that the two companies merge (J.A. 169, ¶61). It would be contrary to the common understanding of the word "passive" to apply it to a stockholder like Bendix who had two seats on the issuer's Board, who used its access to the Board to attempt to merge the two companies, and, when that failed, sold the stock and used the proceeds in an attempt to further one of its core businesses.

Bendix reaped additional advantages by taking a minority, rather than a control, position in ASARCO. From an operational standpoint, the relatively smaller position created less exposure to the cyclicality of ASARCO's earnings (J.A. 104; J.A. 128). Agee believed that a minority position had the further advantage of greater ease of exit (J.A. 135). Moreover, the relatively smaller financial commitment ensured that Bendix would

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[16] Agee defined the term "passive investment" as entailing an absence of "day-to-day or week-to-week management responsibility" with input by the investor into the issuer's affairs only at the level of the issuer's Board (J.A. 83). He distinguished this type of "passive investment" from an investment in a mutual fund. *Id.*

have sufficient financial resources to complete its other contemplated acquisitions for the forest products and industrial/energy groups (J.A. 104). Bendix in fact made these acquisitions. In 1979 it acquired Bass & Company and the Caradco Division of Scoville, both of which companies used forest products as raw materials (J.A. 191, ¶152; J.A. 184, ¶129). In 1980 Bendix spent $300.7 million to acquire Warner & Swasey Company, a machine tool manufacturer, which "enhanced Bendix' position in the machine tools business" (J.A. 191, ¶153; J.A. 183, ¶128).

C. Common Sense And Economic Reality Require That The ASARCO Gain Be Treated As Unitary Income.

Petitioner's argument in a nutshell is that the *only* way of establishing a unitary relationship between Bendix and the ASARCO stock interest is to find a unitary relationship between Bendix and ASARCO on an operational level. The argument conflicts with common sense and has no relation to economic reality.

1. Petitioner's Understanding of the Unitary Business Principle Cannot Be Squared With The Accepted Treatment of Working Capital Investments.

With the possible exception of petitioner,[17] it is generally conceded that interest income earned on the short-term

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[17] In its petition at 13, Allied appears to take issue with the concession of the American Home Products Corporation that income generated from the short-term investment of working capital is unitary income if the taxpayer uses the income and

(Continued on following page)

investment of working capital is unitary income. ASARCO conceded the point. *ASARCO*, 458 *U.S.* at 337, *n*.5 (O'Connor, J., dissenting).[18]

ASARCO's concession was based, not on a unitary relationship between debtor and creditor, but on the relation of the investment to the taxpayer's operations. The fact that the key to apportionability of income is its relationship to the taxpayer's business operations is borne out by the definition of business income under the Uniform Division of Income for Tax Purposes Act. 7A

(Continued from previous page)

underlying investments during the taxable year. *See American Home Products Corp. v. Limbach*, 49 *Ohio St.* 3d 158, 160-62, 551 N.E.2d 201, 204-05, *cert. denied sub nom. Limbach v. American Home Products Corp.*, 111 *S.Ct.* (1990).

[18] State courts that have addressed the issue generally agree. *See, e.g., NCR Corp. v. Comptroller of the Treasury*, 313 *Md.* 118, 544 *A.*2d 764, 772-75 (1988) (interest earned on short-term investments of surplus funds was unitary income, in part because the funds and the income, were routinely used for the company's general cash flow needs, expansion of the business, and retirement of debt); *M. Lowenstein Corp. v. S.C. Tax Comm'n*, 298 *S.C.* 93, 378 *S.E.*2d 272 (Ct. App. 1989) (interest on loans to affiliated corporation was unitary income because the lending and operating functions of the taxpayer were integrated and the interest income was used as working capital); *Lone Star Steel Co. v. Dolan*, 668 *P.*2d 916, 922 (Colo. 1983) (interest on loans to corporate affiliate was unitary; taxpayer was not engaged in a separate money lending business); *Cincinnati, New Orleans & Texas Pacific Ry. v. Ky. Dept. of Rev.*, 684 *S.W.*2d 303, 305 (Ky. Ct. App. 1985) (income from short-term investments was apportionable business income under state law); *Holiday Inns, Inc. v. Olsen*, 692 *S.W.*2d 850, 854 (Tenn. 1985) (same).

Uniform Laws Annotated 331 (West 1985) ("UDITPA").[19] Under UDITPA all income is either apportionable business income or nonbusiness income that is allocable to the commercial domicile. UDITPA, § 1(e). In *Container,* the Court recognized that the Uniform Act, as embodied in the California Revenue and Taxation Code, substantially tracks the unitary business principle and the rationale for formula apportionment. *Container,* 463 *U.S.* at 167. Apportionable business income is defined in UDITPA as:

> [I]ncome arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. [UDITPA, § 1(a)].

As made clear in the definition, "business income" is determined by reference to the "taxpayer's trade or business." There is no reference to the trade or business of anyone else.

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[19] As explained in *ASARCO,* UDITPA "is a tax allocation system approved in 1957 by the National Conference of Commissioners on Uniform State Laws and by the American Bar Association. *ASARCO,* 458 *U.S.* at 310, n.3. At least 21 states have adopted all or portions of UDITPA, while several others have drawn on the Uniform Act's apportionment or other provisions. *Multistate Corp. Inc. Tax Guide,* ¶145 (CCH 1991). UDITPA was adopted as Article IV of the Multistate Tax Compact. *See United States Steel Corp. v. Multistate Tax Comm'n,* 434 *U.S.* 452, 457-58, n.6 (1978). *Id.* The Multistate Tax Commission is composed of the tax administrators of the 16 states that have joined the Multistate Tax Compact, an agreement concerning the state taxation of multistate businesses. *ASARCO,* 458 *U.S.* at 311-12; 1 *Multistate Corp. Inc. Tax Guide, supra,* ¶145.

No good reason appears for treating capital gain income differently from interest income when the income producing asset is integrated with the taxpayer's business operations or is held for a purpose relating to such business operations. The Court has stated as much, noting that "capital transactions can serve either an investment function or an operational function." *Container*, 463 *U.S.* at 180, n.19, (citing *Corn Products Refining Co. v. Commissioner*, 350 *U.S.* 46, 50-53 (1955), *reh'g denied* 350 *U.S.* 943 (1956)).[20] As one well known commentator has observed:

> There is, in point of fact, a variety of situations in which dividends and interest ought to be recognized as apportionable by the States under both the Due Process Clause and sound fiscal policy, in circumstances in which the payor corporations are not part of the recipient's unitary business conducted within the State. The income from temporary investments of working capital pending the need for the funds in the basic operations of the enterprise is one such category. [Hellerstein, *State Taxation I Corporate Income and Franchise Taxes* ¶9.12[3] at S298-99 (Cum. Supp. 1989)].

It cannot reasonably be maintained that only the immediate use of an investment in the day-to-day operations of a taxpayer can create a unitary relationship

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[20] In *Corn Products*, the Court held that a manufacturer of corn products that purchased corn futures to assure a future supply of its principal raw material was required to report the gain on sale of the futures contracts as ordinary income rather than capital gain. In *Arkansas Best Corp. v. Commissioner*, 485 *U.S.* 212 (1988), the Court limited the *Corn Products* doctrine to "hedging transactions that are an integral part of a business inventory purchase system [such that they] fall within the inventory exclusion of [I.R.C.] § 1221." *Id.* at 222.

between an investment and the operations of the taxpayer. *Cf. ASARCO*, 458 *U.S.* at 338 (O'Connor, J., dissenting). Where the business operations of the taxpayer include the acquisition and sale of interests in other corporations or where stock is acquired as part of a longer term business strategy, the "investment decision making" is integrated with the unitary business, and there is no sensible reason to deny unitary treatment. *Id.* at 335. Surely the duration of the investment cannot be the single determinative fact.

2. Petitioner's Theory of the Unitary Business Principle As Applied In This Case Is Inconsistent With Economic Reality.

At least since its decision in *Complete Auto Transit, Inc. v. Brady*, 430 *U.S.* 274 (1977), the Court has articulated an approach to state taxation that focuses on "economic realities," *id.* at 279, and the "practical effect" of a tax affecting interstate commerce. *Mobil*, 445 *U.S.* at 443; *Commonwealth Edison Co. v. Montana*, 453 *U.S.* 609, 616 (1981); *American Trucking Associations, Inc. v. Scheiner*, 483 *U.S.* 266, 294-96 (1987); *Trinova Corp. v. Michigan Dept. of Treasury*, 111 *S.Ct.* 818, 828 (1991) (principles governing state taxation of multistate businesses "seek to accommodate the necessary abstractions of tax theory to the realities of the marketplace." *Id.*).

The economic reality of Bendix' stock interest in ASARCO was that the investment was necessary to the accomplishment of Bendix' strategic goals as described in the company's annual reports, the testimony of its chairman, and the memoranda analyzing the potential acquisition. The economic reality was expressed by the

company's chairman to the effect that financial strategies, including minority stock investments, are as much a part of corporate management as the supervision of a corporation's traditional manufacturing operations (J.A. 133 to 137). Agee's view that businesses consist of "pools of assets" (J.A. 137) was echoed by the State's expert witness, who opined that one of the roles of top management is the continuous identification of investment opportunities in order to maximize stockholder return from a portfolio of investments, some involving operational control of the productive assets and others involving partial ownership (J.A. 141). It is not apparent why New Jersey should be prevented from imposing its CBT consistent with the economic reality of Bendix' situation.

Petitioner belittles New Jersey's argument as being founded on "corporate rhetoric" rather than "operational functions" (Pb35), but in Bendix' case, as distinct from the situation in *Woolworth*, the "rhetoric" materialized in actions that in fact created a unitary link between the ASARCO stock interest and Bendix' operations, *e.g.* the stepping stone nature of the stock purchase, Agee's active, central role in Bendix' acquisitions and every-day manufacturing operations, and the use of the stock proceeds in the attempt to expand Bendix' aerospace activities.

D. The Court's Holdings In *ASARCO* And *Woolworth* Do Not Preclude New Jersey From Taxing A Share Of The ASARCO Gain, But The Court's Broad Language In *ASARCO* Should Be Qualified.

Petitioner argues that in *ASARCO* and *Woolworth* the Court rejected New Jersey's application of the unitary

business principle. Petitioner claims that, at bottom, New Jersey's argument is no different than the business purpose argument advanced by Idaho in *ASARCO* and by New Mexico in *Woolworth*. Petitioner asserts that, since the purported unitary relationships in this case are even weaker than those in *ASARCO* and *Woolworth*, the holdings in those cases will have to be abandoned if the Court should affirm the New Jersey Supreme Court (Pb25 to Pb33). Finally, according to petitioner, the Court's decision in *Container* confirms the Court's rejection of the unitary business theory advanced by New Jersey. These assertions do not withstand analysis.

1. The Record Distinguishes this Case from *ASARCO* and *Woolworth*.

The Court has made clear that broad generalizations in its opinions are not controlling beyond the facts presented in those cases. *Gomillion v. Lightfoot*, 364 *U.S.* 339, 343-44 (1960); *Northern Nat'l. Bank v. Porter Township*, 110 *U.S.* 608, 615 (1884). Thus, the *holdings* in *ASARCO* and *Woolworth* cannot be broader than the facts before the Court, and the facts in those cases differ significantly from those presented here.

ASARCO and *Woolworth* involved the taxation of income (primarily dividends) received from wholly and partially owned subsidiaries received by nondomiciliary corporations. It was undisputed that each corporation did business in the taxing state, Idaho in the case of ASARCO and New Mexico in the case Woolworth. Both states had adopted a version of UDITPA and accordingly distinguished between business income which was apportioned among the states under the standard three-factor

formula and nonbusiness income which was allocated entirely to the commercial domicile. Both states had adopted combined reporting, but New Mexico did not permit it as to foreign affiliates such as Woolworth's that did not do business in New Mexico. Finding insufficient unitary links between the *operations* of the taxpayer and the *operations* of the dividend paying subsidiaries, the Court held in both cases that the nondomiciliary taxing state could not include in apportionable business income the dividends and other income received from the subsidiaries.[21]

The foundation for the Court's holdings in both *ASARCO* and *Woolworth* were the record facts in each case. In pointing out that the facts before it in *ASARCO* differed in critical respects from those in *Mobil*, the majority stated:

> As we have said elsewhere, the application of the unitary-business principle requires in each case a careful examination both of the way in which the corporate enterprise is structured and operates, and of the relationship with the taxing State. [*ASARCO*, 458 *U.S.* at 326, n.22].

In neither case did the record support the state's argument that the taxpayer's investments in its subsidiaries were integrated with its own business operations. As

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[21] Commentators have questioned the Court's application of the unitary business principle in *ASARCO*. Floyd, "The 'Unitary' Business in State Taxation: Confusion at the Supreme Court?" 1982 *B.Y.L. Rev.* 465 (1982); Hellerstein, "State Income Taxation of Multijurisdictional Corporations, Part II: Reflections on *ASARCO* and *Woolworth*, 81 *Mich. L. Rev.* 157, 179 (1982); Note, "The Supreme Court, 1981 Term," 96 *Harv. L. Rev.* 62, 95 (1982).

reflected in the joint appendix in *ASARCO*, the stipulated facts relate exclusively to the functional integration on an operational level between the parent corporation and its subsidiaries.[22] The Multistate Tax Commission auditor noted additional facts suggesting a unitary relationship between the *operations* of ASARCO and certain of its subsidiaries.[23] Nor is there any evidence in the trial court proceeding as printed in the joint appendix in *ASARCO* that ASARCO's investments in the five subsidiaries were integrated *as investments* into ASARCO's operations.[24] In *Woolworth* there appears to have been virtually no factual record. *See Woolworth*, 458 *U.S.* at 359, n.7, 360.

Moreover, the Idaho trial court found as a fact that ASARCO's stock investments were " 'not integral to nor a necessary part of [ASARCO's] business operations. . . .' " *ASARCO*, 458 *U.S.* at 324 n.21 (quoting the appendix to ASARCO's jurisdictional statement at 44a).

The Court was thus confronted with a record that did not support an argument by Idaho that the business use of an intangible should determine the apportionability of the intangible income, a trial court finding that

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[22] *See, e.g. ASARCO*, J.A. at 26a ¶4 (volume of sales); *ASARCO*, J.A. 29a, ¶5 (ownership percentage); *ASARCO*, J.A. 30a, ¶6 (interlocking directors and officers of ASARCO and its subsidiaries).

[23] *See, e.g. ASARCO*, J.A. 89a, ¶5 (flow of services); *ASARCO*, J.A. 94a, ¶3 (significant business activities between the taxpayer and the subsidiary). The single exception appears to be the auditor's contention that the gain on the sale of General Cable stock was apportionable because ASARCO acquired the stock to ensure itself a market (*ASARCO*, J.A. 95a).

[24] See *ASARCO*, J.A. 121a to 137a.

ASARCO's investments in the five subsidiaries were *not* integral to ASARCO's business operations, and, finally, a concession by Idaho "that a unitary business relationship between ASARCO and the subsidiaries is a necessary prerequisite to its taxation of the dividends at issue." *Id.* at 325.

Here, New Jersey does not concede that a unitary relationship between Bendix and ASARCO is necessary in order for New Jersey to tax an apportioned share of the capital gains realized by Bendix. The New Jersey Tax Court found that Bendix' investment in ASARCO was integral to Bendix' business operations. See Pet. App. C at 63a. There is no lapse here between the factual record and New Jersey's argument. The stipulated facts and the deposition of William Agee fully support New Jersey's position on the unitary business principle. If unitary business cases turn on their facts, *ASARCO* and *Woolworth* have little bearing here.

2. New Jersey's Argument Is Not One Of Amorphous Corporate Purpose.

The record facts dispose, as well, of petitioner's argument that New Jersey is making the same business purpose argument that the Court rejected in *ASARCO* and *Woolworth*. While Idaho may have argued that intangible assets should be considered unitary if used for purposes relating to a taxpayer's unitary business, *id.* at 326, there was nothing in the record to establish what that purpose might be nor how, in fact, the investments were " 'acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business.' " *Id.* If the record facts revealed no "operational function" for an

investment, no "overall operational strategy" that included the investment, and no centralized management linking the investment to the taxpayer's operating business, under *Container* the investment would be passive. *See Container*, 463 *U.S.* at 180, n.19.

Here, the record establishes an "operational function" for the ASARCO investment and an "overall operational strategy" linking the ASARCO investment to Bendix' business. To take just one example, the ASARCO stock purchase served three operational functions (1) to further diversify the company, which was a longstanding operational strategy that is documented in the record, (2) to generate capital for one of Bendix' core businesses, the aerospace group, and (3) to gain knowledge of ASARCO's business and the nonferrous metals industry in order to determine whether to enlarge or sell Bendix' interest. These concrete, operationally oriented goals were in substance no different than Container's loans and loan guarantees to its subsidiaries that the Court characterized as "part of an effort to ensure that '[t]he overseas operations of [appellant] continue to grow and to become a more substantial part of the company's strength and profitability.' " *Id.*[25]

Moreover, Bendix' strategies materialized in fact. The record demonstrates that the ASARCO stock interest served to further diversify the company, generated cash for the aerospace sector, and provided the Bendix

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[25] Other operational functions for minority stock positions might include (1) the use of dividends and capital gains as working capital, *see Silent Hoist & Crane Co., Inc. v. Director, Div. of Taxation*, 100 *N.J.* 1, 494 *A.*2d 775, *cert. denied* 474 *U.S.*

(Continued on following page)

directors with sufficient knowledge to prompt an offer to merge the two companies.

3. The Court Should Make Clear That Intercorporate Relationships Are Not The Exclusive Indicia Of A Unitary Business, But It Need Not "Abandon" *ASARCO* Or *Woolworth.*

Despite the fact that *ASARCO* and *Woolworth* are distinguishable on their facts and that New Jersey's concept of a functionally integrated investment is more concrete than the business purpose test advanced in *ASARCO,* there is no getting around the fact that the Court stated in *ASARCO*:

(Continued from previous page)

995 (1985); (2) use of stock as collateral or as the convertibility feature in an issuance of convertible debt, *cf. International Paper Co. v. Director, Div. of Taxation,* 11 *N.J. Tax* 147, 170 (Tax Ct. 1990) (Hopkins, J. dissenting) *aff'd.* N.J. Super Ct., App. Div., No. A-5138-89T5 (May 13, 1991), *certif. denied* N.J. Sup. Ct., No. 33,784 (Oct. 18, 1991); (3) complete diversification as in the case of a conglomerate, *see W.R. Grace & Co. v. Commissioner of Revenue,* 378 Mass. 577, 393 *N.E.*2d 330 (1979). Additional examples can be found in the business income regulations of the Multistate Tax Commission, specifically Reg. IV.1(c)(4), and in the *amicus* brief of California filed in support of New Jersey in this case.

Petitioner's statement (Pb30) that Bendix's investments in corporations other than ASARCO were unitary because these "companies . . . fell squarely within Bendix's four core business groups . . . " is not consistent with the stipulated facts. Over the years Bendix at times invested in businesses in which it had no prior involvement (J.A. ¶130). *See* J.A. 188, ¶139; J.A. 173, ¶¶71, 73, 73a.

> We cannot accept, consistent with recognized due process standards, a definition of 'unitary business' that would permit nondomiciliary states to apportion and tax dividends '[w]here the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State. . . .' [*ASARCO*, 458 *U.S.* at 327 (quoting *Mobil*, 445 *U.S.* at 442)].[26]

Unless the statement is explained and qualified, this area of the law will remain confused.[27]

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[26] While the quoted statement refers to dividends, it was likely intended to apply to capital gains and interest income as well. *See ASARCO*, 458 *U.S.* at 330. However, an issuer whose stock is sold is not the "payor" of the capital gain realized on the sale. Bendix' capital gain on the ASARCO stock sale was not "paid" by ASARCO to Bendix, was never ASARCO's income, and was never taxed in ASARCO's federal or state returns.

[27] State courts have applied the *ASARCO/Woolworth* "payor-payee" rule as the exclusive test, eliminating capital gains and dividends from apportionable income despite evidence that the taxpayer's stock investment activities were an integral part of that taxpayer's unitary business activities. *Pledger v. Illinois Tool Works, Inc.*, 306 *Ark.* 134, 812 *S.W.*2d 101, 105, *cert. denied* 112 *S.Ct.* 418 (1991) (capital gains on sale of stocks non-unitary although investment activities were an integral part of taxpayer's regular business); *International Paper, supra*, 11 *N.J. Tax* at 165 (capital gain on sale of Bard stock nonunitary although stock was pledged to retire corporate debentures); *Corning Glass Works, Inc. v. Virginia Dept. of Taxation*, 241 *Va.* 353, 402 *S.E.*2d 35, 40, *cert. denied* 112 *S.Ct.* 277 (1991) (despite evidence that acquisition and divestiture of stock was a regular and integral part of taxpayer's business activities, capital gain on sale of stock ruled nonunitary).

The problem with the statement is that it is doctrinally unsound. Under the unitary business principle, a nondomiciliary corporation's simple presence in the taxing state is not sufficient to create a nexus to tax income earned at least in part outside the state; there must be "a 'minimal connection' between the interstate activities and the taxing State. . . . " *Mobil*, 445 *U.S.* at 436-37. It makes little sense to say that the activities in question are the activities of a corporation other than the taxpayer/recipient,[28] *e.g.* the activities of the payor of dividend income. As made clear by the Court's earlier unitary business cases, there is certainly no such requirement for apportioning income from ordinary business operations. *See* Pomp and Rudnick, "Federal Tax Concepts as a Guide for State Apportionment of Dividends: Life After *ASARCO*," 12 *Tax Notes* 411, 416 (Nov. 8, 1982). The source of the income, so far as the corporate taxpayer is concerned, is its holding of the investment, *see* "Note,"

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[28] The exception is a combined return where the "taxpayer" in effect is the unitary group consisting of two or more corporations. *See* Hellerstein, "State Income Taxation of Multijurisdictional Corporations, Part II: Reflections on *ASARCO* and *Woolworth*," 81 *Mich. L. Rev.* 157, 182, n.155 (1982). New Jersey has consistently rejected combined reporting, insisting that its tax is on single corporate franchises measured by the income received by that franchise. *See Second Report of the Commission on State Tax Policy*, 97 (1947) (Da2); *Report of the New Jersey Tax Policy Committee, Vol. 5, Non-Property Taxes In a Fair and Equitable Tax System* 29 (1972) (Da5). As the income taxed under the CBT is the income of a single corporate franchise, the activities and income of separate corporations have no relevance to the taxpayer's return. *ASARCO* and *Woolworth*, by focusing exclusively on the payor-payee relationship, force New Jersey to apply a combined reporting concept to a statute that is flatly inconsistent with combined reporting concepts.

96 *Harv. L. Rev.*, *supra*, at 92-93, and the question must be whether that stock holding is integrally related to the taxpayer's business. *Id.* at 95; *see ASARCO*, 458 *U.S.* at 335 (O'Connor, J., dissenting). In determining whether an investment is integrated with the taxpayer's business, control over the issuer and flows of product and services between the taxpayer and the issuer may be the decisive factors, *Mobil*, 445 *U.S.* at 442, but not because of the intercorporate relationships in themselves. Intercorporate relationships are significant for the inferences they create that the *investments* are functionally related to the taxpayer's business operations.

For instance, in the case of wholly-owned subsidiaries selling a substantial portion of their output to the parent-taxpayer, the unitary relationship between the corporations creates a strong presumption that the parent's investment in the subsidiary's stock is functionally integrated with the parent's business operations, *e.g.* to obtain a captive source of supply.[29] But control and functional integration between taxpayer and issuer cannot logically or as a matter of economic reality be the exclusive indicia of functional integration between the investment and the taxpayer's business. Floyd, "The Unitary Business . . . ," 1982 *B.Y.L. Rev.*, *supra* at 482; *Container*, 463 *U.S.* at 179. Integration can be established just as well by an investment's role in the "management of the financial requirements" of the unitary business, *ASARCO*, 458 *U.S.* at 337 (O'Connor, J., dissenting), or its dependence on knowledge gained through the operating business, *id.* at 336, or by other links to the unitary business.

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[29] This was the case with ASARCO's six wholly-owned subsidiaries. *ASARCO*, 458 *U.S.* at 312-13.

The Court should thus clarify the quoted statement from *ASARCO* by holding that the ultimate inquiry is whether an investment is integrated with a taxpayer's business operations and that a unitary relationship between the taxpayer and the issuer of the stock is one, but only one, indicator of the necessary integration.

There is no need to go further and abandon the holdings in *ASARCO* and *Woolworth* for those decisions remain valid based on the facts and arguments there presented. The doctrine of stare decisis is therefore not implicated. *United States v. Ross*, 456 *U.S.* 798, 824 (1982) (stare decisis did not preclude a later decision rejecting the reasoning of an earlier case where the holding of the earlier case was adhered to and legitimate reliance interests were not upset).[30]

4. *Container* Supports New Jersey's Position.

Finally, *Container* supports New Jersey's, not petitioner's, argument. Although the unitary relationships were those *between* Container and its subsidiaries, as indicated above, intercompany relationships must be significant factors in determining which corporations to include in a combined report. The import of *Container* is its recognition that the existence of a unitary business can be shown in any number of ways, *Container*, 463 *U.S.* at 164,

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[30] If stare decisis were implicated, the doctrine has less force in a case involving the Constitution where "correction through legislative action is practically impossible. . . . " *Edelman v. Jordan*, 415 *U.S.* 651, 671, n.14, *reh'g denied* 416 *U.S.* 1000 (1974), (quoting *Burnet v. Coronado Oil & Gas Co.*, 285 *U.S.* 393, 406-08 (1932) (Brandeis, J., dissenting)); *Payne v. Tennessee*, 111 *S.Ct.* 2597, 2609-10 (1991).

179; that all that need be shown by the taxing state is "something beyond the mere flow of funds arising out of a passive investment which renders formula apportionment a reasonable method of taxation, *id.* at 166; its recognition that the ultimate question in the case of investment income is whether the investment "serve[s] either an investment function or an operational function," *id.* at 180, n.19, and its repeated emphasis that the burden in these cases is on the taxpayer to show "by clear and cogent evidence" that the state is taxing extraterritorial income.[31] *Id.* at 164, 175.

Under these standards, Bendix' stock interest in ASARCO was part of Bendix' unitary business. *Container* opens the door to demonstrating the existence of a unitary business through an operational strategy linking business operations and acquisitions. The ASARCO stock interest did more than simply generate a flow of funds; it served an operational function by continuing the historical diversification of the company, by providing Bendix' management with information on the nonferrous metals industry and ASARCO, and by serving as a stepping stone to an acquisition in the area of one of Bendix' core businesses. Petitioner has failed to prove by "clear and cogent evidence" that New Jersey is taxing extraterritorial income.

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[31] A requirement of proof "by clear and cogent evidence" has been likened to establishing that the truth of the asserted matter is "highly probable." *McCormick on Evidence* § 340 (3rd ed. 1984).

E. Petitioner's Proposed Tax Exemption Would Be Unfair To The States And Unnecessary To Protect Interstate Business.

Petitioner's concept of a fair tax on its investment income appears to be virtually no tax at all. Petitioner presumably concedes that Michigan, Bendix' state of commercial domicile, can tax the ASARCO gain. Michigan, however, includes capital gains in the apportionable tax base under the Michigan single business tax. *Mich. Comp. Laws*, §§ 208.3(3) and 208.9 (West 1991).[32] If, as petitioner claims, the ASARCO gain can be taxed by New Jersey only upon proof that ASARCO and Bendix were operating a unitary business, presumably petitioner would take the position that no other nondomiciliary state can tax the income either. It is not unfair or "overzealous" to require that interstate businesses based in a state that apportions investment income apportion that income in other states as well. It is not unfair or "overzealous" for New Jersey to impose a tax amounting to .72% of the ASARCO gain. While double taxation of investment income is a theoretical possibility due to the fact that some states allocate investment income entirely to the commercial domicile while others tax it on an apportioned basis, such double taxation has not been shown here, and, until it is shown, the Court should not assume that it is a significant problem. *See Moorman*, 437 *U.S.* at 279-80; *Mobil*, 445 *U.S.* at 444-46.

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[32] The business income portion of the Michigan single business tax is based on federal taxable income. *Mich. Comp. Laws* § 208.3(3) (West 1991). A corporation's federal taxable income includes capital gains. *I.R.C.* § 11(a), § 63(a), § 61(a) (1991).

In sum, Bendix has failed to show by "clear and cogent evidence" that a share of the ASARCO gain is beyond New Jersey's taxing power. The Court should thus adhere to its longstanding rule of not upsetting state taxing schemes and deferring to the judgment of state courts. *Container,* 463 *U.S.* at 175-76.

CONCLUSION

For the foregoing reasons the judgment of the Supreme Court of New Jersey should be affirmed.

Respectfully submitted,

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New Jersey Administrative Code
Title 18, § 7-11.15 (1991)

18:7-11.15 Consolidated returns

(a) Corporations are not permitted to file consolidated returns. Provided, however, any business conducted by an individual, partnership, or corporation or any other entity, or any combination thereof holding a license pursuant to the Casino Control Act shall file a consolidated corporation business tax return as described at N.J.A.C. 18:7-1.17

(b) Except as provided in (a) above, where a taxpayer has filed a consolidated return with the Internal Revenue Service for Federal income tax purposes, it must complete its return under the act and must reflect its entire net income and entire net worth as if it had filed its Federal return on its own separate basis.

STATE OF NEW JERSEY

SECOND REPORT

OF

The Commission on State Tax Policy

Part I: Taxation of Tangible Personal Property

Part II: Corporation Business Tax Act (1945)

Submitted to the Governor and to the Legislature, March 24, 1947

* * *

[p. 96]

3. *Consolidated Returns*

The Corporation Business Tax Act (1945) provides that:

> "Every domestic or foreign corporation which is not hereinafter exempted shall pay an annual franchise tax . . . for the privilege of having or exercising its corporate franchise in this State, or for the privilege of doing business, employing or owning capital or property, or maintaining an office in this State. And such franchise tax shall be in lieu of all other State, county or local taxation upon or measured by intangible personal property used in business by corporations liable to taxation under this act." (Laws 1945, ch. 162, sec. 2.)

Thus, under the act, all corporations chartered in New Jersey and all foreign corporations qualified to do business in New Jersey are taxable. The tax is assessed for the corporate privilege and in lieu of taxation as property

of corporate owned intangibles. Corporations which operate as a single enterprise under a single charter are taxed for a single privilege according to their size as measured by net worth. Corporations which choose to operate through subsidiaries exercise more than a single privilege and they are taxed accordingly. In rare instances multiple corporate units

[p. 97]

pay less tax than they would as a single unit. In general, however, the tax upon multiple corporate units exceeds the tax which would be assessed upon the group as a single unit.

Use of consolidated returns under the Corporation Business Tax Act would have the effect of grouping two or more corporations and assessing a franchise tax upon their combined net worth after elimination of inter-corporate accounts. The resulting tax would depend upon group holdings and group activity and would not reflect a payment for individual corporate charters or privileges. For large families of corporations such as those controlled by some of New Jersey's holding companies, it would virtually eliminate the tax for corporate privileges exercised by any but the parent corporation. Because consolidation would combine allocation factors as well as balance sheet accounts, it would enable corporate families operating on a national or international basis to escape all but a nominal tax in New Jersey.

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[p. 100]

While these data as tabulated from the 1946 corporation business tax returns are not adequate to determine the exact effect of consolidated returns, they do indicate the implications of such a revision. *First,* consolidated returns would result in a greatly reduced tax base and tax. It would virtually eliminate the tax liability of holding corporations and a large part of the reduction in tax base would occur among large corporations which account for a major portion of the tax. *Second,* consolidated returns would grant reduced group tax rates for charters to families of corporations and thus depart from the payment for each corporate privilege or charter. Against this background the *Commission* recommends:

THAT PROVISIONS OF THE CORPORATION BUSINESS TAX ACT (1945) WHICH DO NOT PERMIT THE FILING OF CONSOLIDATED RETURNS REMAIN UNCHANGED.

* * *

Part V

of the Report of the

NEW JERSEY TAX POLICY COMMITTEE

Non-Property Taxes in a Fair
and Equitable Tax System

Submitted to Governor William T. Cahill
pursuant to Executive Order No. 5 of 1970

TRENTON, NEW JERSEY

February 23, 1972

* * *

Consolidated Returns

[p. 28]

Formulary apportionment is a technique developed by the States for determining the portion of the measure of a tax attributable to the State, where the taxpayer's activities, assets and business are located in more than one State, or are in part outside the country. One of the most troublesome and controversial issues in State corporation taxation has been how to determine the State's share of the net income, or capital stock, or other tax measure of an enterprise conducted through affiliated corporations operating in various States and in foreign countries. This issue has taken on increasing importance as business has expanded and corporate pyramids have multiplied, and is now exacerbated by the growth of the corporate conglomerate.

The States sought to deal with affiliated groups of controlled corporations which siphoned off some income or other taxable base, through artificially fixed prices for.

goods or services and other intercompany arrangements, by enacting provisions for re-allocating income and deductions on an arm's length basis. This is the instrumentality employed by Section 482 of the Federal Internal Revenue Code for dealing with intercompany dealing among affiliated and related United States and foreign corporations. As experience developed and as businesses expanded, this type of tool proved inadequate to the task of determining the income attributable to a State in which a corporation was conducting an operating function of an integrated enterprise organized in a multicorporate structure. This was not merely because of the difficulties involved in determining reasonable arm's length prices, but for the more fundamental reason that separate accounting was increasingly regarded by State tax administrators, by its nature, as an unsatisfactory technique for determining the share of the income of a unitary business that ought to be attributed to the various States in which the business is conducted.[25] As a consequence, apportionment by formula began to be extended to multicorporate, unitary businesses, with the consolidated or combined return employed as the method of achieving this result.[26]

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[25] For the history of the development of formulary apportionment as applied to a single corporation doing business in more than one State, and its subsequent extension by some States to an affiliated or controlled group of corporations, see Hellerstein, State and Local Taxation: Cases and Materials, Ch. 8 (3rd ed. 1969).

[26] The Report of the Special Subcommittee on State Taxation of Interstate Commerce, Note 13, supra, enumerates 23 States "that have provisions authorizing their administrators to require or permit consolidated returns in order clearly to reflect income", citing:

(Continued on following page)

The unitary business doctrine has been recognized by the courts of this State under the Corporation Business Tax, as applied to a single corporation doing a multistate business.[27] However, in the absence of any explicit provision in the statute for consolidated reporting, the courts have upheld the Director's regulation that consolidated

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Ariz. Rev. Stat., Sec. 43135(e); Cal. Rev. and Tax Code Secs. 25104, 25105; Colo. Rev. Stat., Sec. 138-1-28; Conn. Gen. Stat., Secs. 12-221, 223; Del. Code tit. 30, Sec. 1906; Ga. Code, Sec. 92-3202; Reg. Sec. 92-3209; Iowa Reg. 22.37; Kans, Reg. 92-4-98; Ky. Rev. Stat., Secs. 141.205(1), (3); La. Rev. Stat., Sec. 47:95; Md. Code art. 81, Sec. 296; Minn. Stat., Sec. 290.34(2); Mont. Reg. 208; N.Y. Tax Law, Sec. 211.4; N.C. Gen. Stat., Sec. 105-143; N. Dak. Cent. Code, Sec. 57-38-14; Okla. Stat. tit. 68, Secs. 878(i), (j); Oreg. Rev. Stat., Sec. 317.360; S.C. Code, Secs. 65-285, 297; Utah Reg. 4; Vt. Reg. Arts. 600, 607; Va. Code, Secs 58-136, 138, 139; Wis. Rev. Stat., Sec. 71.11(7)(b). (Vol. I, p. 246, note 217).

It then declares that, "of these, at least five States have provisions which appear broad enough to require or permit a combined report", Arizona, California, Georgia, Minnesota and New York, as to which it appears consolidation may be permitted or required without a showing of artificial pricing or other income distorting arrangements. Under the Wisconsin corporate tax, the Department of Taxation may require the filing of consolidated returns. Wisc. Stats., Sec. 71.11-7(b).

[27] Household Finance Corp. v. Director, Division of Taxation, 36 *N.J.* 353, 177 *A.*2d 738 (1962); F.W. Woolworth Co. v. Director, Division of Taxation, 45 *N.J.* 460, 213 *A.*2d 1 (1965).

returns for a unitary enterprise, operating through affiliated corporations, are not permitted.[28]

If a consolidated return provision were to be acted, [sic] we would recommend that taxpayers be given the right to file consolidated returns, and that the Director of the Division of Taxation likewise have the power to require the filing of a consolidated return, provided, of course, the statutory standards prescribed for consolidation are met. We know of no justification for the use of a one-way street, i.e., as is true in some States, where the taxpayer has the privilege of filing a consolidated return, but such reporting may not be required by the taxing authority,[29] or vice versa.[30]

[p. 29]

In the *Second Report* of the Commission on State Tax Policy made in 1947, consolidated returns were considered and rejected, on the ground that the effect would be only to reduce the taxes of New Jersey holding companies and their subsidiaries (pp. 96, et seq.). The 1947 Corporation Business Tax, however, was a very different levy from the present tax; that statute imposed only a net worth tax. A 50% deduction was allowed for investments in subsidiaries only to the extent of the subsidiary's New Jersey allocation percentage, whereas under the present

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[28] United States Steel Corp. v. Director, Division of Taxation, 38 ~~N.J.~~ 533, 186 *A.*2d 266 (1962).

[29] See Mass. Gen. Laws, ch. 63, Sec. 39.

[30] See the Wisconsin provision, Note 31, supra.

statute, there are two types of deductions allowed for subsidiary capital: (a) 50% of the holding company's book investment in the subsidiary, regardless of whether the latter is taxable in New Jersey, plus (b) the continuation of the 1947 deduction of 50% of the subsidiary's New Jersey allocation percentage, applied to the book value of the investment. (Secs. 4(d) and 9).

In 1947, no income tax was imposed under the Corporation Business Tax. Under the present corporation net income tax, dividends from subsidiaries are already eliminated, so that their elimination as intercompany items in a consolidated return would have no tax effect (Sec. 4(k)). At the present time, the income of a holding company operating in New Jersey is taxed, as is the income of its subsidiaries, to the extent they do business in the State. The income of the other affiliates in the unitary business is not taken into account. But, under consolidating income reporting, the net income of the entire unitary enterprise, including companies not doing business in the State, would be taken into account under the apportionment formula in determining the portion of the income of the unitary business that should be attributed to New Jersey.

Consequently, the conclusion reached in the 1947 report that consolidated returns would result in a reduction of revenues may not be true today. No data are available from which a reasonably workable estimate can be made as to whether, to what extent, and in which industries, revenues would increase or decrease, as a result of the enactment of a consolidated return provision. Moreover, there are troublesome problems, and

sharply conflicting approaches by State tax administrators and representatives of business as to how to define the elusive concept of a unitary business, the scope of an affiliated group to be included in a consolidated return, whether subsidiaries operating in foreign countries should be included, the treatment of intercompany dividends, and the like.[31] Legislation has been pending in Congress since 1964 for the adoption of a Federal statute, which would require the States to follow uniform Congressionally established standards and rules for consolidated returns.[32] The States have generally opposed this legislation, and efforts to reconcile the views of the various States and the larger businesses have been made, and are continuing, in the hope that acceptable solutions may be found which could be embodied in Federal or State legislation. While these efforts have thus far not achieved the wide concensus required to produce a viable solution acceptable to the interested parties, they are continuing.

Accordingly, in view of the importance of substantial uniformity of the laws and regulations of at least the major States in dealing with the unitary business and

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[31] For an analysis of the conflicting approaches to the unitary business doctrine and consolidated returns, see Hellerstein, "Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business", 21 National Tax Journal (1968); and Rudolph, "State Taxation of Interstate business: The Unitary Business Concept and Affiliated Corporate Groups", 25 Tax Law Review 171 (1970).

[32] These provisions are included in bills pending before Congress referred to in Note 13, supra.

consolidated return issues, it is our conclusion that this State ought to await further action by the States or by Congress, hopefully growing out of the joint efforts of State tax administrators and representatives of business, to find mutually acceptable solutions, before modifying the present law in this area.

The Committee recommends:

The existing provisions of the Corporation Business Tax, which have been administered and interpreted as debarring the application of the unitary business doctrine to an enterprise consisting of separate, affiliated corporations and as precluding the filing of consolidated returns, should remain unchanged, pending further developments in this area designed to achieve a uniform treatment of these matters by the various States.

*   *   *